PROFESSIONAL ADVISERS ONLY

The 7IM Retirement Income Service

A technical guide

Succeeding together

7IM

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An introduction

It's time for something better

In recent years there has been a radical change in how people entering retirement generate income. The number of people enjoying final salary pensions is in decline and far fewer people are opting for annuities. Meanwhile, demand for income drawdown strategies has never been higher. With the introduction of pension freedoms in 2015, people have more control than ever over how they use their pension pots.

That's why we created the 7IM Retirement Income Service (RIS). It is a bespoke solution designed to support the retirement plans that you've created for your clients. It provides greater control over income in retirement while mitigating many of the pitfalls associated with income drawdown. It is important to understand that as with any investment your capital is at risk and returns cannot be guaranteed.

Above all, the 7IM RIS allows you and your clients to remain in control of their capital. It adapts to changing personal needs and circumstances, using sophisticated modelling techniques to manage risk and provides you with a clear view of how the plan is progressing.

This guide looks at how the 7IM Retirement Income Service (RIS) is built and provides information about our research. It should be read in conjunction with the '7IM Retirement Income Service – Your income, your way' brochure.

About 7IM

We're 7IM. As an investment management business, established in 2002, we help individuals, families and trustees manage their money to meet their financial needs and aspirations.

We look after over £19 billion of our clients' money. Our experienced team of almost 500 people continually focus on delivering the best outcomes for our clients and we pride ourselves on delivering exceptional customer service.

2002

7IM was established as an investment business in 2002.

£19bn

Currently handling over £19 billion of our clients' money.

500

Drawing on the experience of over 500 employees.

A robust, repeatable process

When constructing an income drawdown plan, it is essential to put in place an arrangement which is suited to the client's immediate requirements and has the potential to be sustainable in the future.

However, the only thing which we can really be sure of in relation to drawdown is that things will not work out quite as planned.

Whether it's because of changes in the client's circumstances or external factors such as poor investment markets, taxation or legislative alterations, from time to time the plan will need to be adapted.

For this reason, it is essential to have a robust and effective review mechanism to ensure the plan remains suitable.

The 7IM RIS is built to ensure that both at outset and review your client's drawdown arrangement is aligned to their requirements.

A robust, repeatable process
Continued

The client inputs

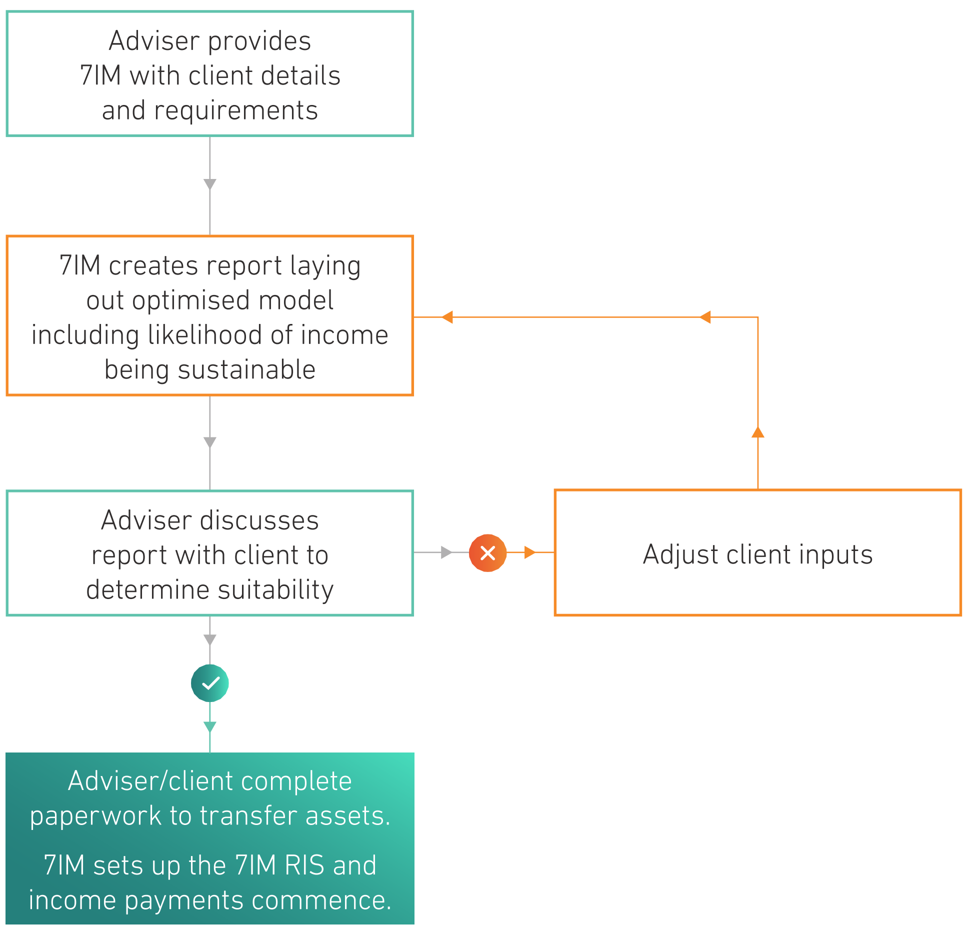
The starting point in the 7IM RIS process is for the adviser and client to complete the 7IM form which provides 7IM with the necessary data to model a personalised forecast for the likelihood of a good client outcome.

The key client inputs are:

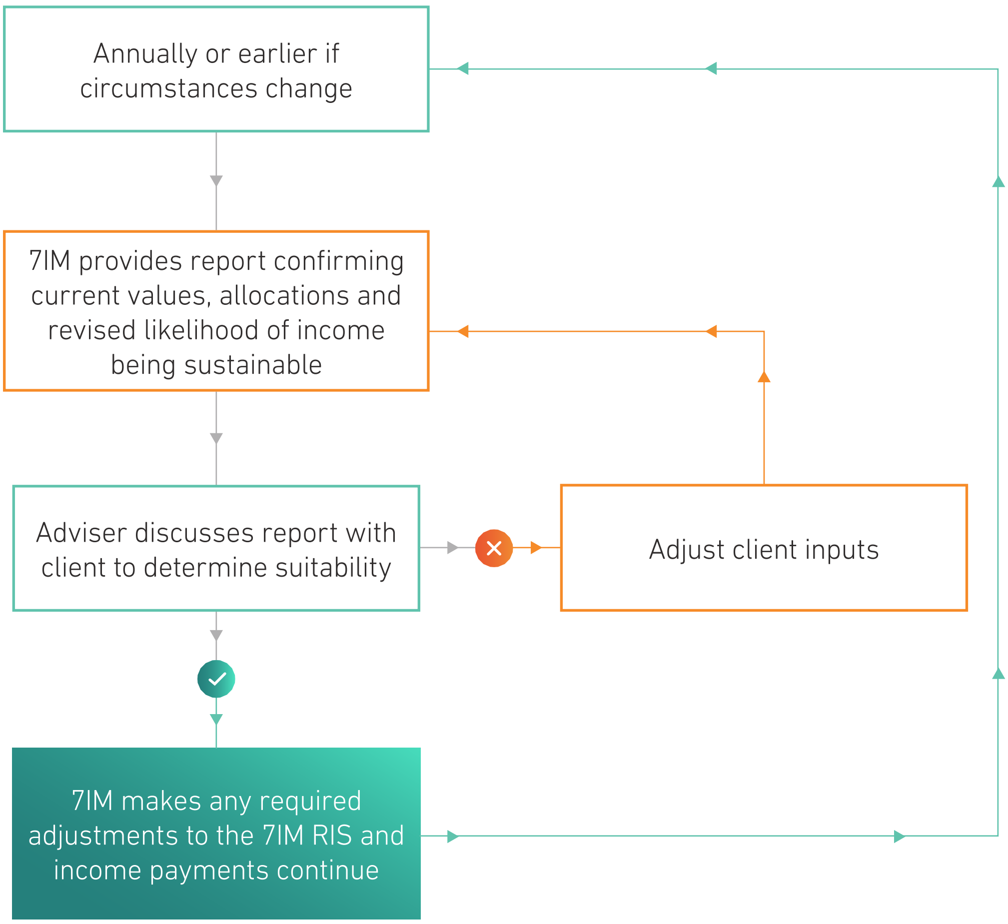
- Capital to be invested (in which tax wrappers?)
- Rate of income withdrawal (%)
- Level or escalating withdrawals (0%, 1%, 2%, 3%)
- Term of withdrawals (typically estimated life expectancy)
- Risk profile
- Ongoing adviser charge (%)

What is the process for advisers?

At outset



At review


Annually or earlier if circumstances change
7IM provides report confirming current values, allocations and revised likelihood of income being sustainable
Adviser discusses report with client to determine suitability
Adjust client inputs
7IM makes any required adjustments to the 7IM RIS and income payments continue

A detailed understanding

The science behind forecasting a good client outcome

The 7IM RIS takes the client inputs then overlays them with additional and more complex inputs and assumptions to create a model that provides a level of probability regarding the likelihood of the client having excess capital at the end of the plan.

The process takes the client's income requirement (including any selected escalation) to create an array of future expected cash flows. These cash flows are then overlaid with guideline investment growth rates relating directly to 7IM's risk-rated investment portfolios. These forward looking guidelines are the latest available long run return views, with an adjustment made for additional costs, such as fund charges, discretionary fees, and advice charges. Each year these guideline returns are refreshed and as part of the service the plan is re-evaluated against the updated data.

A common weakness of cash flow plans is that they operate on a deterministic basis and frequently fail to take adequate account of the risk that investment returns will naturally deviate from the forecasted average growth rates. The 7IM RIS addresses this by using information based on the historical experience of 7IM clients since 2003.

This moves our cash flow plan from a straight-line approach to one based on thousands of simulations/trials, which incorporate the potentially damaging effects of pound cost ravaging and sequence risk.

By using a statistical process known as Monte Carlo Simulation, we chop the 7IM historical returns into blocks of six-week returns and reorder them several thousand times to generate myriad paths over time (an extract of this is shown in Diagram 1). This gives each scenario a wide spread of possible returns, including samples far worse than those actually experienced: for instance, a simulation might be unlucky enough to end up with a sequence of blocks entirely made up of the nadirs of 2008 and 2011. For each set of inputs 10,000 scenarios are run, in total there are over 50,000 combinations of assumptions we consider. So a total of over 500,000,000 different outcomes can be assessed.

The percentage of test scenarios that run out of money before the end of the retirement plan gives financial advisers and their clients an indication of how robust a plan may be in the face of the uncertainty around future investment returns. 7IM recognises that this level of detail, although key to providing a robust plan, is not easy for clients to interpret so we simplify the output for clients from a Monte Carlo Simulation (Diagram 1) to reflect the likelihood of there being excess capital at the end of a plan. This simplification process is shown in Diagrams 1 to 3.

A detailed understanding
Continued

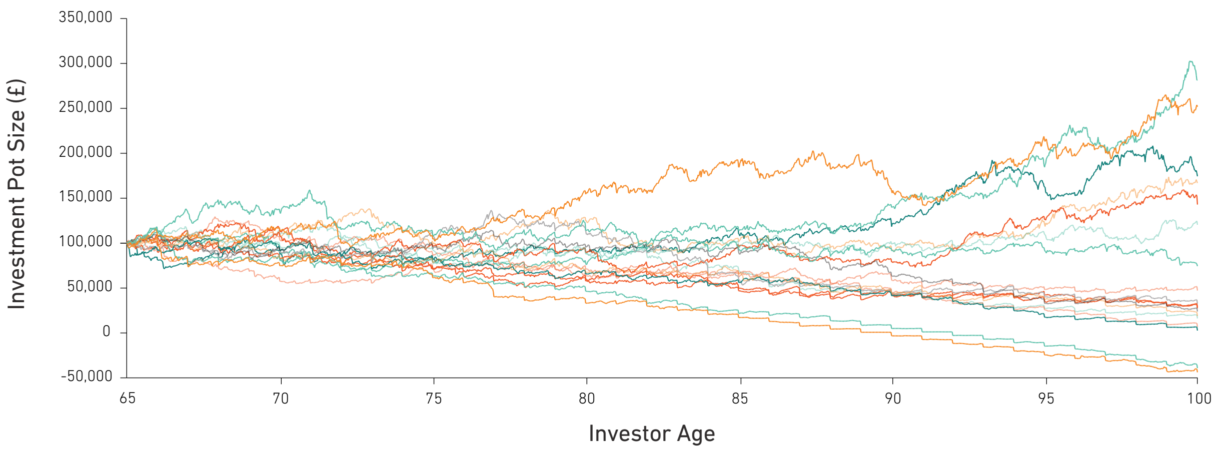
Based on the output we will take the results and determine the likelihood of excess capital being available at the end of the plan (Diagram 3).

The output is robust and assumes that no action is taken over the whole course of the plan. In reality, rather than being a chance of success versus failure, a more realistic (and encouraging) term is to describe deviations from the expected as the 'chance of adjustment' versus the 'chance of excess'.

Where a plan begins to veer off course, this would be identified at the annual review process, at which point, adjustments can be made to expectations for near-term goals to avoid a failure of the plan at some later date. Simply put, the plan is dynamic and maintains its flexibility to adapt to a client's changing needs and circumstances.

To help clients understanding, we convert this to a gauge based on their goals.

Diagram 1 – Monte Carlo Simulation



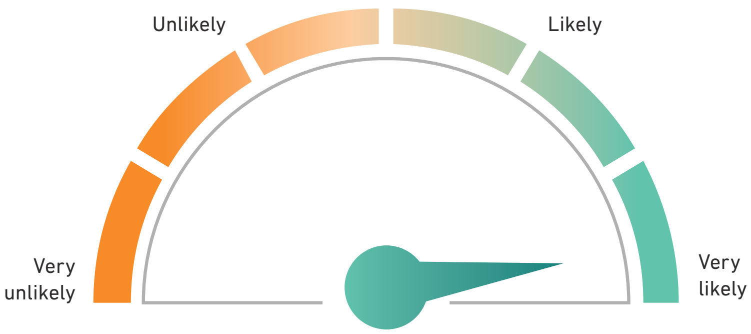
Source: 7IM. This chart shows a range of simulated investment outcomes, starting at age 65 with an initial investment pot of £100,000. Simulations overlay forward looking guideline returns for a given risk profile with the risk historically experienced by that profile (proxied using 7IM OEIC fund returns since inception). A 4% withdrawal rate is applied to each path to generate the final investment outcome. The simulation process re-orders historical blocks of volatility to generate returns that are much better/worse than historically realised returns. Past performance is not a guide to future returns.

Diagram 2 – Withdrawal Rates

Number of Years

Withdrawal Rate	10	15	20	25	30	35	40
7.0%	99%	72%	25%	7%	2%	1%	1%
6.5%	>99%	83%	39%	13%	5%	1%	1%
6.0%	>99%	91%	52%	21%	10%	5%	3%
5.5%	>99%	96%	69%	36%	18%	10%	5%
5.0%	>99%	98%	81%	50%	30%	18%	10%
4.5%	>99%	>99%	94%	73%	49%	31%	19%
4.0%	>99%	>99%	97%	85%	66%	50%	36%
3.5%	>99%	>99%	99%	93%	81%	66%	52%
3.0%	>99%	>99%	>99%	98%	93%	84%	74%
2.5%	>99%	>99%	>99%	>99%	98%	95%	90%
2.0%	>99%	>99%	>99%	>99%	>99%	99%	98%

Diagram 3 – 7IM's Excess Capital Likelihood Calculator



The structure

7IM believes a bucketing approach, if appropriately constructed and executed, offers a robust answer to the questions asked of a retirement income strategy:

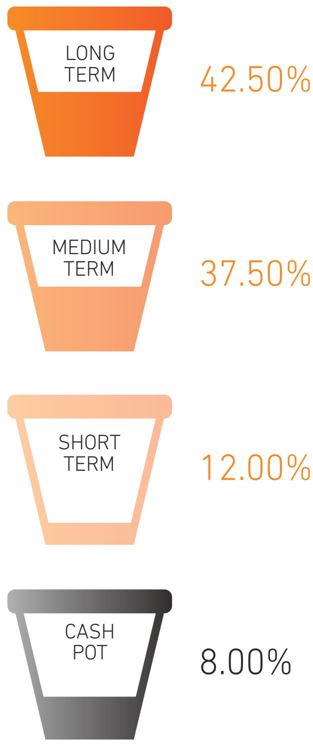
- It reflects our belief that in retirement focus should be on total return rather than pure income seeking strategies. These strategies which narrow the available investment universe to those that provide a 'natural income' and in doing so, restrict asset allocation.
- It doesn't require the introduction of additional liquidity risk or complexity i.e. structured products.
- It assists in the management of sequence risk/pound cost ravaging. In a bucketing approach, the ability to hold a cash buffer reduces the likelihood of needing to crystallise losses in periods of weaker market performance.
- Specific buckets help clients to visualise how their capital is being held and this understanding can help with their engagement and willingness to stick with the process.

For all its benefits, running a comprehensive bucketing strategy which mixes numerous risk profiled pots into one portfolio across various tax wrappers presents a significant challenge, not least in terms of administration. However, at 7IM we have developed an approach where a client's investment portfolio can be treated as a single entity by the financial adviser, with an asset mix that remains appropriate to the level of risk the client is able and willing to take.

Simply put, for each risk profile and income level we have calculated a benchmark set of weights for cash, low, medium and high risk investments. These are calculated in a way that combine to form a portfolio that matches directly with an individual's risk profile and in so doing helps to minimise the drag that might otherwise be caused by holding cash.

Let's take an example of a client with a balanced risk profile who wishes to draw 4% income.

We would allocate the capital into the various pots, as follows:



The cash pot

Having too much cash can cause a drag on long-term portfolio performance, but too little may be insufficient to help manage sequence risk. Getting this balance right is crucial.

The purpose of the cash pot is threefold:

1

To cover 12 months of planned income between reviews.

2

To help reduce the impact of sequence risk.

A client who withdraws income from their retirement portfolio during or just after a market downturn may seriously deplete the value of their account. When unit prices are low, a client needs to sell more units to provide the same level of income as would have been the case in a buoyant market, consequentially less money remains to grow as the market recovers.

3

To help counter the mental accounting bias that many clients exhibit.

Allowing for this behaviour can help investors feel more comfortable with their investment strategy.

The 7IM RIS maintains a cash buffer which can be used to provide the income during these periods of market downturn, therefore delaying the need to sell down.

The structure
Continued

The dilemma

To determine the size of an appropriate cash buffer, the 7IM RIS uses historic data relating to the actual performance of the various 7IM risk profiles which go back as far as 2003. To validate our findings, we also tested additional sources of returns starting in the 1980s, which supported these results.

The goal of the cash buffer is not to defend with 100% certainty against all market falls but rather to provide some flexibility to make small adjustments over time in relation to market downturns. Holding 'large' cash balances may provide more of a buffer, however they create additional difficulties when managing the risk of a portfolio in line with an investor's risk profile.

The following table shows the number of months it has taken for 7IM Multi-Asset portfolios to recover from declines after historical peaks in performance (i.e. the duration a portfolio is underwater versus previous investment highs). The underwater period for each observation is calculated by looking at the historical high achieved by a portfolio and counting how many periods that was in the past.

Referring to the table, we can see that 83% of the time, a Balanced portfolio has recovered from a fall in value within 12 months. Framed differently, clients could have expected to still be below previous highs after 12 months for 17% of the time.

If this was the case, we can look out a further 12 months (up to 24 months in total) to see the probability that a fund would still be below its previous high. As we can see, a Balanced portfolio has recovered from an underwater period after 24 months 96.5% of the time. A client invested in this portfolio could have expected to be underwater after 24 months only 3.5% of the time.

Two years of income, split into one current year's income and one year's buffer, covers potential downturns in all but the most extreme of circumstances. It also provides a greater degree of certainty for clients deemed to have a lower risk appetite. Two years of income covers a high probability (>95%) of eventualities, is more defensive for lower risk profiles and creates a manageable drag on the rest of the portfolio.

Percentile	Moderately Cautious	Balanced	Moderately Adventurous
99%	27	29	32
98%	25	27	30
97%	23	25	28
96%	21	23	26
95%	19	21	24
94%	18	19	22
93%	17	18	20
92%	16	18	19
91%	15	17	18
90%	14	16	18
89%	13	16	17
88%	13	15	16
87%	**12**	14	16
86%	12	14	15
85%	12	13	14
84%	11	13	14
83%	**11**	**12**	13
82%	10	12	13
81%	**10**	**12**	**12**
80%	10	11	12

This table shows the percentiles for underwater periods, in months, for different risk profiles run by 7IM (based on 7IM Multi Manager C share class funds since inception). The underwater period for each observation is calculated by looking at the historical high achieved by a portfolio and counting how many periods that was in the past. The distribution of these calculations across all periods are summarised below.

Past performance is not a guide to future returns.

The structure
Continued

Short-term pots

Beyond holding two years in cash, an additional three years' worth of income will be invested in the short-term pot. This pot is linked and relative to the client's risk appetite. The 7IM RIS takes the approach of using a risk profile lower than the client's overall risk profile (e.g. for a Balanced client the near term pot is invested in the Moderately Cautious portfolio). This combination of the near term and cash pots covers a five year investment horizon as a default, a time horizon that could be considered short term in our opinion.

Medium and long-term pots

It is essential that overall the portfolio matches the client's risk profile. Therefore, the medium and long-term pots must offset the lower risk of cash and near term pots.

For each client we calculate the percentage needed in the medium and long-term pots, to keep that client within their overall risk profile. The model used here is updated on an annual basis, as our long-term expectations and benchmark positioning changes. The model uses the same underlying methodology used by our independent Risk Management Team as part of their daily monitoring. However, it focuses on longer term horizons, as is appropriate for the nature of the portfolios we are building as part of the 7IM RIS.

Importantly, the way the pots are combined relies on the underlying assets used remaining consistent with the expectations for each risk profile. This requirement emphasises the importance of the Risk Management Team at 7IM.

Risk Management Team

The management of risk is an integral part of 7IM's investment process.

Our Risk Management Team consists of five investment professionals who independently monitor and assess our positioning daily. They provide a system of checks and balances which help to strengthen our rigorous and disciplined investment process. Their process ensures the risk of portfolios continues to be in line with expectations. The team uses a variety of metrics and models, including stress tests, to ensure the individual portfolios are positioned in a way that is consistent with their risk profiles.

These portfolios are the building blocks for an investor's ultimate portfolio. So for the investor's ultimate portfolio to remain consistent with a risk profile, so too, must the building blocks. Our Risk Management Team ensures, on a daily basis, this is the case, providing detailed understanding of the risk we are taking in the portfolios.

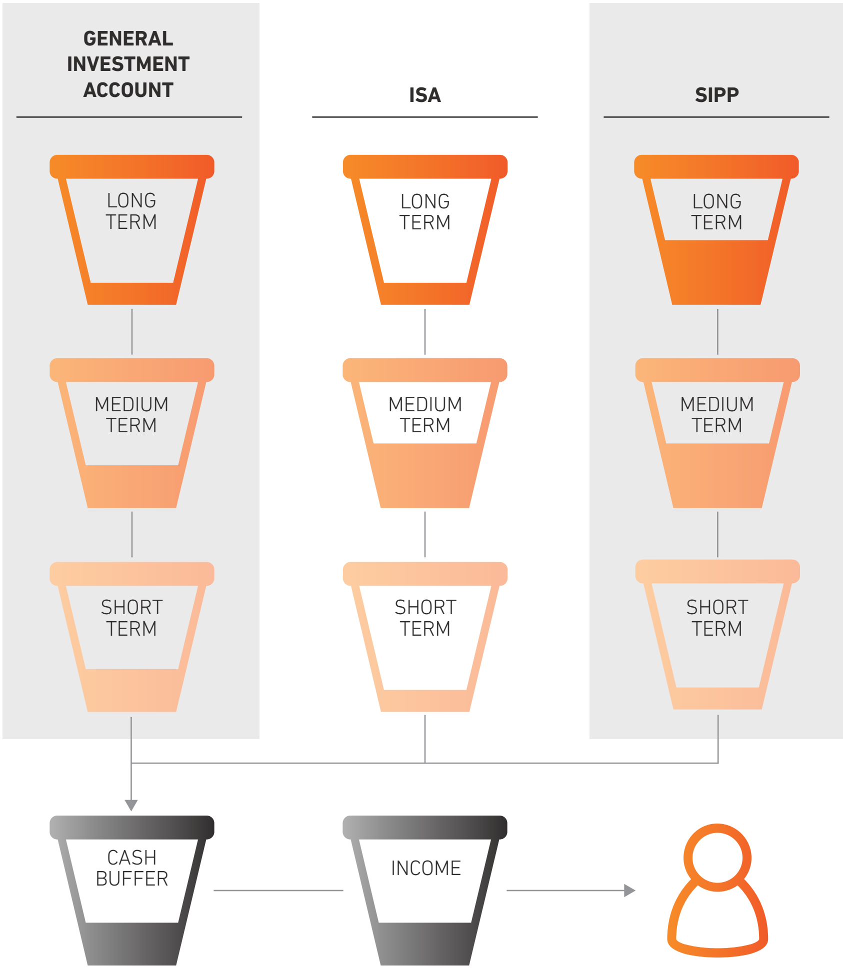
Further detail on our risk management team and process is available upon request.

Implementation across tax wrappers

When using multiple tax wrappers, whilst you might expect to deplete any unwrapped holdings first, followed by ISAs and then by SIPP holdings, it is for the adviser and client to instruct 7IM as to the order of depletion based on the client's specific financial planning objectives.

Naturally, the client's priorities may change over time, for example, in a given year, their personal tax situation may make it preferable to switch the emphasis from tax free income to taxable income. Under instruction from the adviser or client, we can adapt the withdrawal method to suit these goals. In each scenario the various cash and investment pots are structured across these tax wrappers with the medium/long-term pots held in the accounts that have the longest time horizon and the cash and near terms pots in those that will be immediately paying out income.

This is illustrated in the below picture:



Reviewing the portfolio

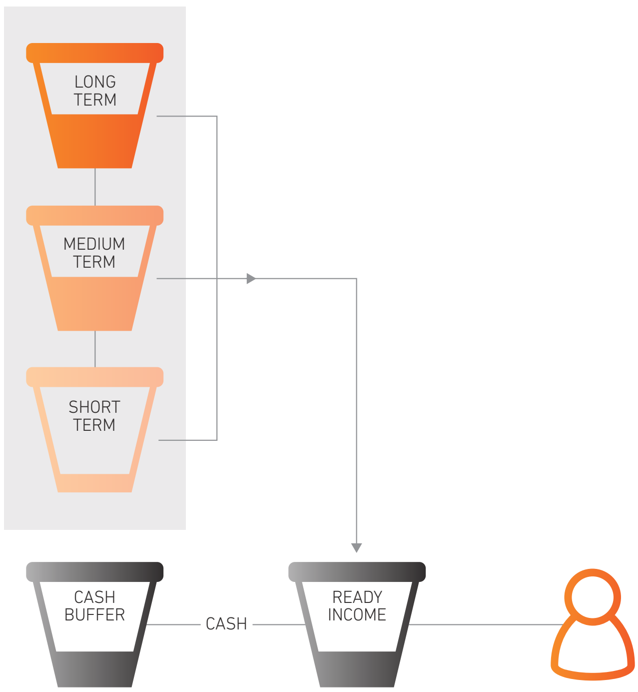
We bring the science together within a real life portfolio by investing the various pots in the 7IM risk rated portfolios. On an ongoing basis a strict protocol will monitor individual client portfolios to ensure that they remain within the volatility boundaries of the agreed risk profile.

The client's 7IM RIS plan is reviewed formally on an annual basis with the client's financial adviser. At this point we produce an Annual Review Report and take any action needed to bring the portfolio back in line with the plan. The annual review process will usually involve topping up cash from the relevant buckets to take individual pot weights back to target allocations, but as detailed below this might not always be the case.

On the previous page we introduced the concept of the various time horizon pots being held within multiple tax wrappers, dependent on withdrawal strategy. In the diagrams below we have removed reference to tax wrappers to illustrate how 7IM manages withdrawals and rebalances in different market conditions. The arrows indicate where the top ups come from.

When investments are up

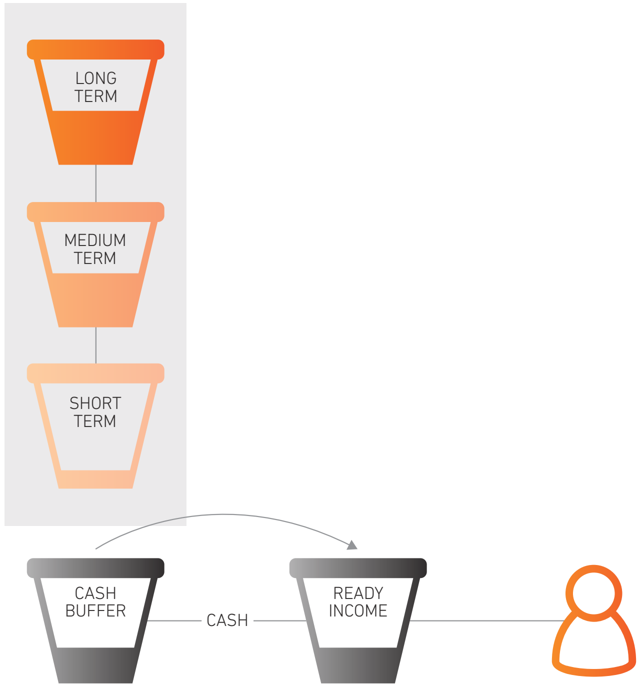
Cash is topped up and portfolio is fully rebalanced based on the reviewed client inputs.



When investments are down

The portfolio is not rebalanced. The cash buffer is used to top up the next 12 months income.

If investments have not recovered by the time the income and cash buffer are depleted, the 7IM RIS would pay the monthly income from pots in a way that keeps an investor consistent with their risk profile, whilst aiming to do so from the pots that have fallen the least.

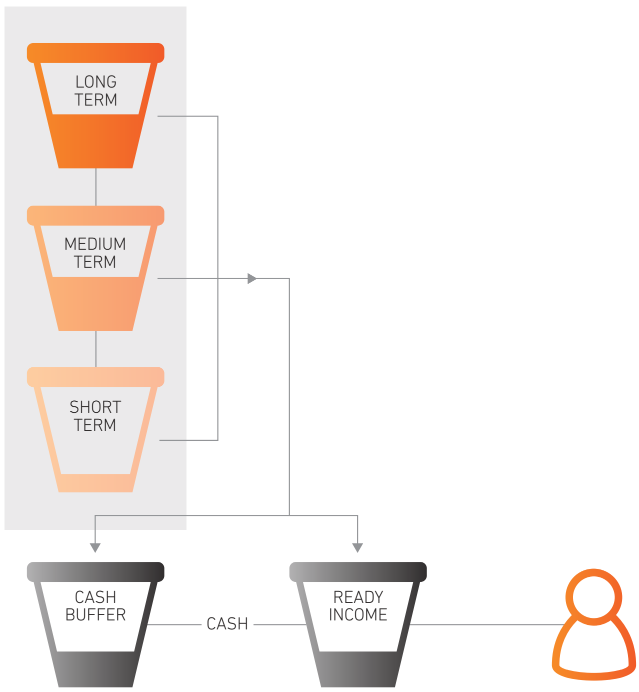


When investments recover

Cash is topped up and portfolio is rebalanced based on the reviewed client inputs.

This robust approach at review results in consistent client outcomes and a repeatable process built on the principles outlined above.

In the unlikely event that there are conflicts between tax, investment performance or risk we will always discuss this with you, as the client's financial adviser, to ensure the correct client outcome at that time.



Client communication

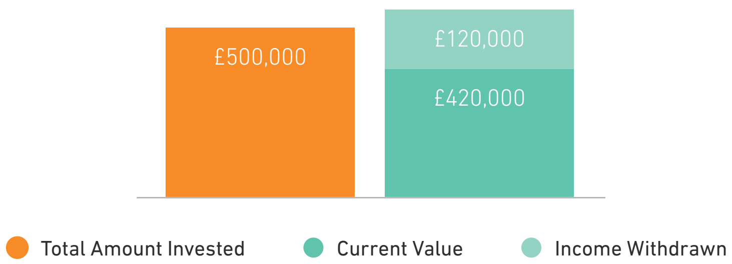
At 7IM we firmly believe that financial planning is most effective when the client is fully engaged in the process and this is never more important than in the drawdown phase of their lives.

Naturally, the depth of the relationship they have with their financial adviser is core to this engagement. However, we believe that it can be significantly improved by giving clients a clear, concise picture, which answers their key concerns, in language they understand.

To this end, the ongoing reports produced by 7IM for the adviser to discuss with their client focus upon three key factors:

01

How the current portfolio value compares with the initial investment value on opening the 7IM RIS, including detail on how much income has been taken.

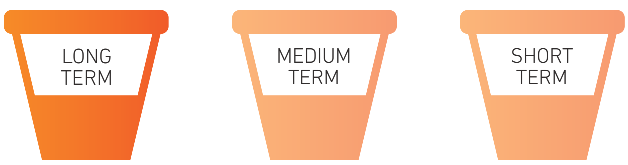


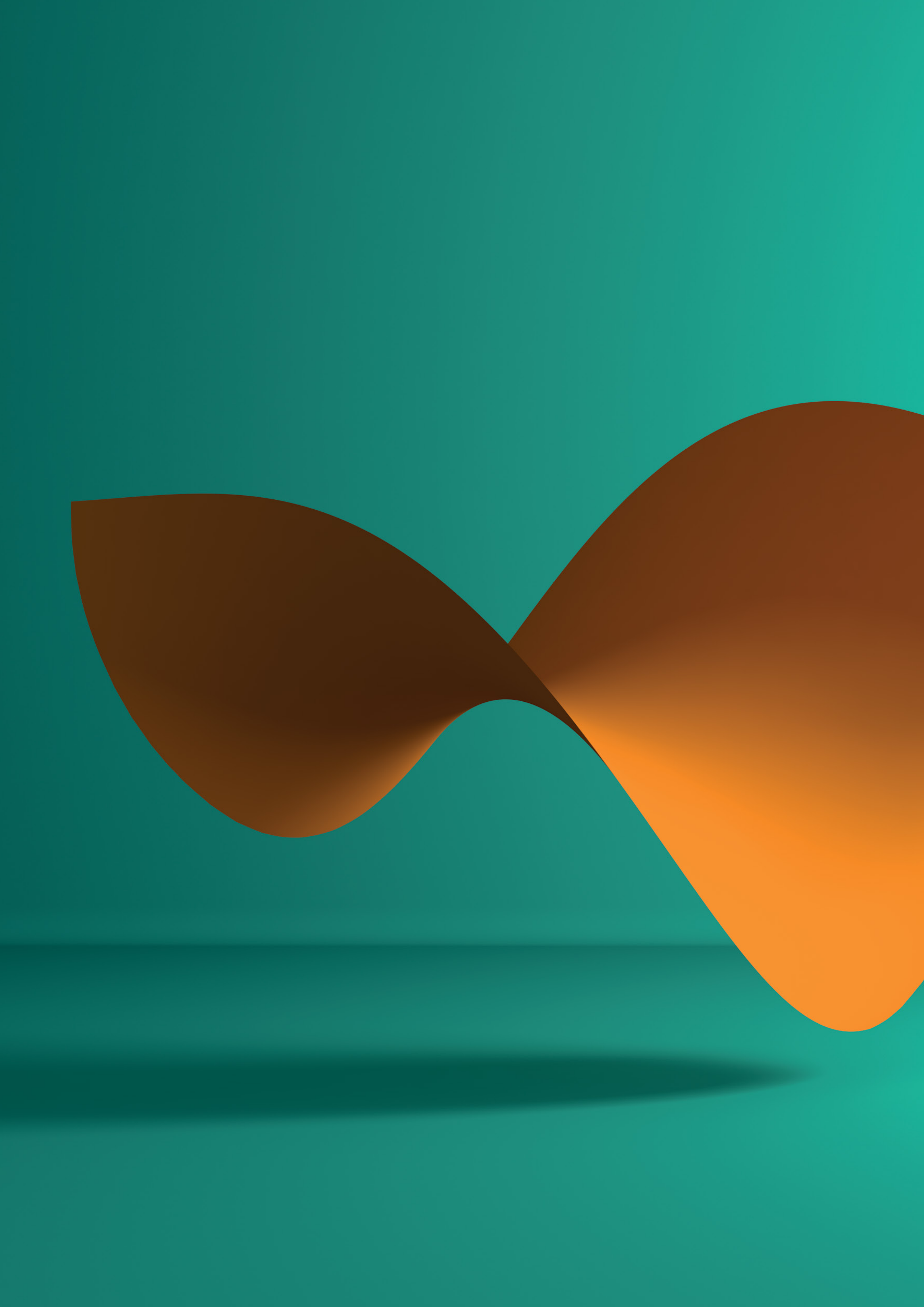
02

An updated likelihood of the income requirement being achieved.

03

How the investments will be split across the different time horizons for the coming year.





Summary

Clients who use the 7IM RIS will, in conjunction with their financial adviser, be able to make an informed decision about the income they can take from their retirement portfolio and how any short-term decisions impact their long-term goals. The 7IM RIS is a dynamic solution that will be reviewed annually or upon request.

If you would like further information regarding our Retirement Income Service:

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